RESEARCH *Brief*

University of Michigan Retirement Research Center

Pension Reform in Mexico: Effect of Pension Fund Fees on Fund Balances

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The introduction of individual or personal retirement accounts (PRA) has been considered as one important reform option for the U.S. Social Security program. There are a number of issues related to PRA schemes that make studying other countries' experiences with PRAs highly instructive for policy makers in the U.S. in order to avoid certain pitfalls of implementation, should this option be considered further, or to add policy designs that remedy some disadvantages. For example, PRA schemes in their purest form do not leave room for redistribution. Mexico has implemented a minimum pension benefit to provide for those with otherwise insufficient pension income.

Background

In 1997 Mexico introduced Personal Retirement Accounts (PRAs) which, after a transition phase, will completely replace the pay-as-you-go (PAYG) system. The PRAs are managed by private retirement fund managers (AFORES). The PRA design is based on three pillars: first, a flat rate minimum floor that is the minimum pension guaranteed by the government; second, personal retirement accounts managed by private pension fund managers, and third, voluntary saving accounts for retirement (World Bank, 1994). In the case of public pension systems that provide a defined benefit, the risk is borne by the government. The PRA system distributes the risk of saving for retirement in a different way compared to such DB schemes. In the first pillar, the government bears the risk for lowerincome workers guaranteeing a minimum pension for those most disadvantaged in the labor market. The second pillar, introduces financial instruments for saving for retirement and the risk is borne by the employee. The third pillar provides complementary saving options to the mandatory second pillar for saving for retirement with the benefit of tax advantages.

The PRA system in the Mexican case has some redistributive components: a) a monthly social quota deposited in the individual account, equivalent to 5.55% of the minimum wage of Mexico City, and b) a minimum pension guarantee equivalent to the minimum wage of Mexico City. Chile was the first country to introduce this type of pension reform from a PAYG-scheme to PRAs. The Mexican system has several things in common with the Chilean pension system, but there are also some important differences: the guaranteed minimum is higher in Mexico; there is no guaranteed minimum rate of return for pension funds as is the case in Chile; but the Mexican government makes contributions to the individual accounts equivalent to 0.425 percent of a worker's wage and the monthly social quota.

Impact of Fund Fees

We use administrative data from CONSAR, the regulatory agency of the PRA system, to assess how pension fund management fees affect outcomes and how this varies by pension fund. We find that fees drain pension accu-

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mulations by up to 25 percent of what would have been accumulated without fees. As a result many individuals, especially of the transition generation, will receive only the minimum pension guarantee because their accumulations will not be sufficient to fund a higher pension. The extent of this happening is important to gauge the additional cost to the government. Irrespective of the accumulated pension balances the fees lower well-being during retirement, in some cases significantly so.

Implications

Special attention should be paid therefore to the design of fees when contemplating the introduction of PRA systems and also when studying how such a reform might affect economic preparation for retirement. In the Mexican case there are three different types of fees (load factor, balance and interest) that need to be taken into account. To enhance transparency for individuals it would appear advisable to restrict the types of fees to one common one to be used by all pension funds. Understanding the long-term consequences of even just one type of fee is not a straightforward exercise for individuals.

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